Kudlow's Guest Commentary

Download Options

Budget Deficit Confusion

March 24, 2004
Thomas E. Nugent* (212) 644-8610

The recent battles in Congress over the budget deficit have resurrected an idea from the early Nineties known as PAYGO. Under this proposal, any future tax cuts that aren't offset by other measures to raise tax revenues—either through other tax increases or spending cuts—must receive 60 votes in the Senate, not just a majority (51). This self-imposed limit on the Senate's ability to encourage fiscal policy initiatives is tied to the fears that growing budget deficits will burden our grandchildren. On CNBC recently, Charles Stenholm, Democratic representative from Texas and one proponent of this idea, put forth his concerns in an interview with Steve Liesman.

Congressman Stenholm:

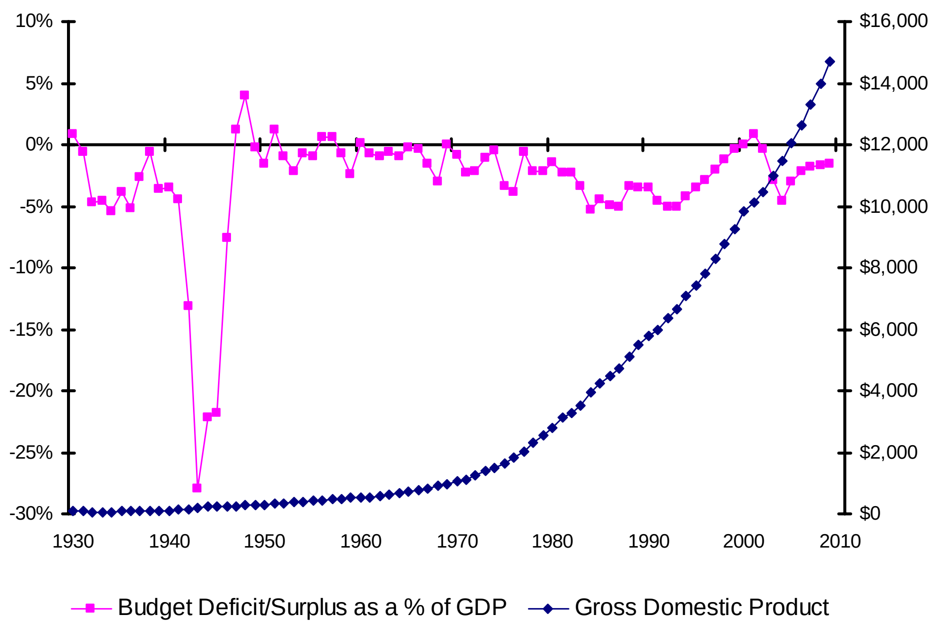
> "We have been following the economic game plan that the leadership of the House continues to insist on now for almost 3½ years. What has it given us--the largest deficits in the history of our country. I think that is a prescription for long-term economic chaos for this country."

One might ask the Congressman: "Why is it a prescription for long-term economic chaos for this country"? or "What historical evidence do you have that budget deficits undermine the positive outlook for the country"?

When we examine the history of budget deficits and surpluses since 1930, we find that our country has seldom experienced a sustained budget surplus. Over this time period we experienced only nine years of budget surplus and 66 years of budget deficits. On the other hand, ten years of consecutive budget surpluses from 1920 through 1929 did nothing to derail the greatest economic depression in our history during the next ten years.

Given the fact that the U.S. has flourished during periods of time when budget deficits were large both absolutely during the Reagan years and relatively during World War II, there is virtually no evidence that budget deficits lead to economic chaos. History tells us that the opposite is true. One reason is that fiscal stimulus can add incentives to increase consumer demand and investment supply to the economy. This triggers increased output, rising incomes and lower unemployment. Budget deficits add to savings, they don't detract from them. Apparently Stenholm thinks in terms of personal economics when he sees budget deficits as bad things. He imagines that the federal government will run out of money just like an individual can go broke if he or she spends more than is earned or saved. Unfortunately for Congressman Stenholm and his cohorts, that is not how our macro economy works.

Under floating exchange rates, i.e., a fiat currency system, all government liabilities are denominated in U.S. dollars, an asset over which the government has total control. As long as the government maintains the value of the currency, it has the unique ability to spend money subject only to policies that would debase the currency. We are no longer under a gold standard or under a promise to redeem currency for gold. All foreign holders of dollars have two options: they can either spend them on U.S. goods and services or continue to hold them. The U.S. government promises only to give dollars in exchange for government debt. To demonstrate the fact that budget deficits do not negatively impact the economy, the following exhibit plots this relationship from 1930 to deficits estimated by the White House through 2009.



As we have learned during the recent economic downturn, monetary policy failed to stimulate economic activity at least as a mechanism to encourage increased business loan demand. The stock market languished during the first two years of monetary ease and didn't begin a sustainable rally until the second quarter of 2003 when the second true supply-side tax cut package began to impact the economy. When events occur, such as the Internet bubble and the technology meltdown in 2000, or the 9/11 attack, the government must step in to stem the economic downtrend. Policies of fiscal and monetary ease truncated the weakening economy in 2001 and limited the downturn to a mild recession.

While Congressman Stenholm complains that the past 3½ years have brought us a large budget deficit, he fails to recognize that the deficit rescued the U.S. economy from hard times. In a recent editorial in the Wall Street Journal, economist Brian Westbury documents the value of fiscal stimulus in the current economic recovery:

- In the two most recent quarters, real GDP has expanded at a 6.1% annual rate, the fastest growth in 20 years.

- According to the Bureau of Labor Statistics, 1.4 million civilian jobs have been created in the past year.

- In the past twelve months, inflation-adjusted retail sales grew by 3% and stand at an all-time record high.

- According to the Institute for Supply Management (ISM), manufacturing activity has operated at the fastest rate in 20 years during the past three months. In February, the ISM employment index climbed to a 16-year high.

- Non-farm productivity expanded by 5.4% in the past year, its fastest rate of growth in 23 years.

- The Dow Jones Industrial Average has increased by 35% in the past year.

- Last year, 1.09 million new homes were sold (an all-time record high) and the average sales price for those homes increased 10%.

- Corporate profits rose to an all-time record high in the fourth quarter of 2003.

Why people of education and experience reject facts and favor stories is beyond me, yet Stenholm goes on with these unfounded expectations:

Congressman Stenholm:

> "[We are} going to borrow another trillion dollars in the next year and a half--the interest on that alone is the largest tax increase that I've seen--voted upon in my 25 years in the Congress."

How is interest on the federal debt a tax increase? Is this just another interpretation of how the deficit will undermine our grandchildren? The evidence suggests that acceleration in growth in the U.S. economy is the elixir that will provide a higher standard of living for our children, not a lower one. Look again at the deficit chart above and see if you can see the close relationship between rising deficits over the past seventy-five years and the chaos these deficits produced in the economy.

The sad truth in an election year is that Democrats like Stenholm will do anything they can to sidetrack the president's economic growth program. If they succeed they believe that an election victory isn't too far behind. When one looks past media bias and checks out home values, substantially lower mortgage rates, the ease at which one can finance the purchase of an automobile, low inflation rates that don't rob wage earners of the value of their work effort and a president who stands up to the threat of terrorism around the world, I find it hard to believe that the economics and politics of Congressman Stenholm will go very far.

** Thomas E. Nugent is Chief Investment Officer for Victoria Capital Management in South Carolina.*

Kudlow & Co. LLC	**Lawrence Kudlow, CEO**
One Dag Hammarskjold Plaza	Susan Varga, COO
885 Second Avenue, 26th Floor	John Park, Economic Associate
New York, New York 10017	John Sullivan, Managing Director
212-644-8610 (p) 212-588-1636 (f)	James Higgins, Managing Director
www.kudlow.com	Sam Munson, Research Associate